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In the Supreme Court of the United States

OCTOBER TERM, 1927

No. 341

D. B. HEINER, COLLECTOR OF UNITED STATES INTERNAL REVENUE for the Twenty-third District of Pennsylvania, Petitioner

v.

JAMES R. TINDLE AND THE UNION TRUST COMPANY of Pittsburgh, Coexecutors of the Last Will and Testament of Philander C. Knox

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the District Court (R. 15) is reported in 17 F. (2d) 522. The opinion of the Circuit Court of Appeals (R. 26) is reported in 18 F. (2d) 452.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered April 4, 1927. (R. 28.) Petition for

certiorari was filed June 30, 1927, and granted October 24, 1927 (R. 29), under the provisions of Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

THE QUESTIONS PRESENTED

The case presents first the question whether Section 214 (a) (5) of the Revenue Act of 1918, providing that in computing net income for income-tax purposes there shall be allowed as deductions losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with the trade or business, contemplates a deduction for a loss resulting from the sale of property acquired for and used as a residence by the taxpayer, but which later, before its sale, was leased and occupied by tenants.

If the above question be answered in the affirmative, the case presents the further question whether the basis for the purpose of ascertaining the loss sustained from the sale of the property is its original cost, its value on the date when the taxpayer ceased to use it as a residence and leased it to tenants, or, in the case of property acquired before March 1, 1913, its value on that date.

THE STATUTE AND REGULATIONS

The Revenue Act of 1918, c. 18, 40 Stat. 1057, 1060, 1066–1067, 1069, provides as follows:

> SEC. 202. (a) That for the purpose of ascertaining the gain derived or loss sus-

tained from the sale or other disposition of property, real, personal, or mixed, the basis shall be—

(1) In the case of property acquired before March 1, 1913, the fair market price or value of such property as of that date; and

(2) In the case of property acquired on or after that date, the cost thereof; or the inventory value, if the inventory is made in accordance with section 203.

(b) When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any; * * *.

* * * * *

Sec. 214. (a) That in computing net income there shall be allowed as deductions:

* * * * *

(5) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with the trade or business; * * *

* * * * *

Sec. 215. That in computing net income no deduction shall in any case be allowed in respect of—

(a) Personal, living, or family expenses;

* * * * *

Regulations 45, as promulgated April 17, 1919, provide as follows:

Art. 141. *Losses.*—* * * A loss in the sale of an individual's residence is not deductible.

This was amended on January 28, 1921, and thereafter reads as follows:

> ART. 141. *Losses.*—* * * A loss in the sale of residential property is not deductible unless the property was purchased or constructed by the taxpayer with a view to its subsequent sale for pecuniary profit.

This provision is also contained, unchanged, in Regulations 62 under the Revenue Act of 1921, Regulations 65 under the Revenue Act of 1924, and Regulations 69 under the Revenue Act of 1926.

STATEMENT

Findings of fact requested by the respondents (R. 19–21) were approved and adopted in their entirety by the District Court, although that court disapproved and rejected the respondent's requested conclusions of law and rendered judgment in favor of the petititoner (R. 23). The facts are therefore undisputed.

In the years 1887–1888 Philander C. Knox, the taxpayer, now deceased, built a residence in Pittsburgh. A short time later he built a stable. The land was acquired in three transactions, in 1886, 1887, and 1892, respectively. (R. 20.) The cost of the entire property was approximately $172,000. (R. 21.) The necessary inference from the findings is that it was his family residence until 1901, when, having been elected United States Senator, Mr. Knox leased the property for three and one-half years and other leases to various tenants followed

until 1920, when the property was sold for $73,706.79. (R. 20–21.) At no time after the leasing of the property in 1901 was it occupied by Mr. Knox or by his family or relatives, and he forthwith established an actual and legal residence at a place elsewhere in Pittsburgh. (R. 21.) The fair market value of the property on March 1, 1913, was $120,000. (R. 21.) There is no finding and no evidence as to the value of the property in 1901, when the first lease was made.

In his income-tax return for the year 1920 the taxpayer claimed as a deduction from income, as a loss suffered in the sale of the property in question, the difference between the March 1, 1913, value of the property less depreciation and the selling price of the property. (R. 19–20.) The Commissioner of Internal Revenue disallowed the deduction, an additional tax was assessed and paid under protest, and a claim for refund was filed and rejected. (R. 21.) The taxpayer's executors then brought this suit to recover the amount of the additional tax so assessed and paid. After the suit was brought the respondent's contention as to a second item in dispute was conceded by the petitioner and refund was made, so that item is no longer involved in the case. (R. 21.)

The District Court for the Western District of Pennsylvania decided the case in favor of the present petitioner. (R. 23.) The judgment of the District Court was reversed by the Circuit Court of Appeals for the Third Circuit. (R. 28.)

SPECIFICATION OF ERRORS TO BE URGED

The petitioner contends that the Circuit Court of Appeals, Third Circuit, erred—

I. In reversing the judgment of the District Court of the United States for the Western District of Pennsylvania.

II. In holding that the transaction which resulted in a loss by the sale of the taxpayer's property was entered into for profit.

III. In holding that the transaction which resulted in a loss by the sale of the property was entered into by the leasing of the property.

SUMMARY OF ARGUMENT

The acquisition of the property in question by the taxpayer for his residence in 1887 was not a transaction entered into for profit within the meaning of Section 214(a)(5) of the Revenue Act of 1918. It does not appear that the acquisition of the property was to save rent, and in any event a saving of rent would not be profit, and the saving would be of a family or living expense not itself deductible.

It is doubtful whether the leasing of the property in 1901 made the subsequent ownership thereof a new transaction entered into for profit within the meaning of the statute. It would seem that the transaction terminated by the sale of the property must have been entered into by its purchase, regardless of what different uses were made of it in the meantime.

The practical difficulties which would be involved in treating each change in the use of property as a new transaction for the purpose of determining gain or loss may well have led Congress to adopt this rule. That Congress intended to make the character of the transaction at the date of acquisition of property determinative of whether a loss resulting from its sale is or is not deductible is indicated (1) by the fact that under Section 202 of the Revenue Act of 1918, as construed by this Court in *United States* v. *Flannery,* 268 U. S. 98, and *McCaughn* v. *Ludington,* 268 U. S. 106, cost is always a factor in determining the gain or loss resulting from a sale of property, and the Act provides no formula using value at the time of any change in the use of property in place of cost, and (2) by the fact that the regulations of the Treasury Department since January 28, 1921, have taken the view that the question whether or not a transaction is entered into for profit is to be determined upon the basis of intention at the time of the acquisition of property, without regard to subsequent change in its use, and the fact that Congress has re-enacted Section 214(a)(5) without change in the Revenue Acts of 1921, 1924, and 1926, thus indicating its approval of the Treasury Department's interpretation.

There is nothing in the Revenue Act of 1918 to justify making the character of the use of the property on March 1, 1913, determinative of whether or not the loss incurred upon its sale was deduct-

ible. The transaction resulting in the loss was entered into either in 1887, when the property was acquired, or in 1901, when it was first leased.

Even if it be assumed that the transaction terminated by the sale of the property was one entered into for profit within the meaning of Section 214 (a) (5) of the Revenue Act of 1918, and that any loss sustained as a result of such transaction was a proper deduction in computing net income, the only logical basis for determining gain or loss is the value in 1901, when the residential use ceased and the leasing began, and as this does not appear in the case there is no showing that any loss was sustained.

ARGUMENT

I

THE ACQUISITION OF THE PROPERTY IN QUESTION BY THE TAXPAYER FOR HIS RESIDENCE IN 1887 WAS NOT A TRANSACTION ENTERED INTO FOR PROFIT WITHIN THE MEANING OF SECTION 214 (A) (5) OF THE REVENUE ACT OF 1918

The Circuit Court of Appeals concedes that the acquisition of the property by the taxpayer for a residence in 1887 was not a transaction entered into for profit, but "a distinctively home, residential, one." The suggestion was made in respondents' brief in opposition that the acquisition of a residence is a transaction for profit if entered into to save rent or transportation charges; that profit means net profit and arises just as much from cut-

ting down expenses as it does from increasing gross income.

The short answer to this is that the rent of a dwelling saved by owning one is a personal living or family expense, which, under Section 215 of the Revenue Act of 1918, is not allowed as a deduction, and if the expense saved is not deductible the cost of saving it is not. Besides, there was no finding that the acquisition of this dwelling, costing $172,000, was to save expenses.

The mere fact that a building is used as a residence does not necessarily mean that it was not acquired for profit. Recognition of this fact probably led to the amendment of Article 141 of Regulations 45, which originally prohibited deduction of "a loss in the sale of an individual's residence" and as amended prohibited deduction only of "a loss in the sale of residential property * * * unless the property was purchased or constructed by the taxpayer with a view to its subsequent sale for pecuniary profit."

The Board of Tax Appeals in a series of cases has held that decision of the question whether or not a residence was acquired for profit depends upon whether, on all of the facts, it appears that the predominating factor leading to its acquisition was the prospect of future profit, or the intention to use it as a home. (*Appeal of Robert W. Williams*, 1 B. T. A. 1101; *Appeal of Helen Converse Thorpe*, 3 B. T. A. 1006; *Appeal of Henry DeFord*, 7 B. T. A. 630; *Appeal of Sidney W. Sinsheimer*,

7 B. T. A. 1099; *Appeal of John N. Hughes,* 8 B. T. A. 206.) Certainly in the present case it can not be seriously contended that the prospect of future profit was the predominating factor leading to the acquisition of the property in question in 1887.

II

IT IS DOUBTFUL WHETHER THE LEASING OF THE PROPERTY IN 1901 MADE THE SUBSEQUENT OWNERSHIP THEREOF A NEW TRANSACTION ENTERED INTO FOR PROFIT WITHIN THE MEANING OF THE STATUTE

The real question in the case is whether the leasing of the property in 1901 made its subsequent ownership a new transaction entered into for profit within the meaning of the Revenue Act of 1918. The District Judge held that the leasing had no such effect, saying (R. 18):

> The transaction in question is one which began with the purchase and ended with the sale. The transaction was the ownership of the property and was ended when the property was sold. It can not be fairly said that this was entered into for profit but was entered into for the purpose of providing a home for the taxpayer. The transaction which was begun by the leasing of the property ended when the lease was ended, and it is not suggested that this was a loss. This is true of each succeeding lease. The transaction which was ended by the sale of the property seems clearly to have been the one which was begun by its purchase.

The Circuit Court of Appeals, while apparently basing its conclusion primarily on other grounds discussed in Point III of this brief, nevertheless indicated that it thought the ownership of the property in question should be divided into two transactions, a residential one, which ceased in 1901, and a business venture, which commenced in that year.

The question, of course, is what Congress intended. It may be admitted that Congress might logically have provided that losses resulting from retention of property for business purposes should be deductible although the property was originally acquired as a residence, but it is doubtful whether the Revenue Act of 1918 can be so construed. Giving the language used its ordinary meaning, it would seem that, as the District Judge held, the transaction terminated by the sale of the property must have been entered into by its purchase, regardless of what different uses were made of it in the meantime. Nor can such a rule be said to be unreasonable.

It is worthy of note that the Act of 1913 (c. 16, 38 Stat. 114, 167) merely allowed as deductions losses "actually sustained during the year, incurred in trade," and losses arising from certain casualties, while Section 5 (a) Fifth of the Revenue Act of 1916 (c. 463, 39 Stat. 756, 759) allowed the deduction of losses sustained in transactions entered into for profit but not connected with business or trade only to the extent of profits arising from

similar transactions. The practical difficulties which would be involved in treating each change in the use of property as a new transaction for the purpose of determining gain or loss, including determination of when the use has actually changed and fixing of market value at varying dates, may well have led Congress to make the character of the transaction at the date of acquisition of property determinative of whether a loss resulting from its sale is or is not deductible, regardless of changes in use and fluctuations in value during the period of ownership.

That this was the intention of Congress is indicated by the fact that Section 202 of the Revenue Act of 1918, providing for the determination of gain or loss, does not seem to be appropriate if a change in the use of property be regarded as a new transaction. That section provides that for the purpose of ascertaining the gain derived or loss sustained from the sale of property, the basis shall be—

> (1) In the case of property acquired before March 1, 1913, the fair market price or value of such property as of that date; and
>
> (2) In the case of property acquired on or after that date, the cost thereof; * * *

In *United States* v. *Flannery,* 268 U. S. 98, and *McCaughn* v. *Ludington,* 268 U. S. 106, this Court held that the Act of 1918 allows a deduction to the extent only that an actual loss is sustained from an investment, as measured by the difference between

the purchase and sales prices of the property. In the *Flannery case* it was said (page 103):

> * * * we think it should be held that the Act of 1918 imposed a tax and allowed a deduction to the extent only that an actual gain was derived or an actual loss sustained from the investment, and that the provision in reference to the market value on March 1, 1913, was applicable only where there was such an actual gain or loss, that is, that this provision was merely a limitation upon the amount of the actual gain or loss that would otherwise have been taxable or deductible.

It results that cost is always a factor in the determination of gain or loss from the sale of property, even though the property was acquired before March 1, 1913. In the present case no cost is properly available. The cost of the property in 1887 for residential purposes manifestly can not be used as the cost of the alleged new transaction entered into for profit in 1901. If the ownership of the property after 1901 was a new transaction for the purpose of deciding whether it was entered into for profit, it must also have been a new transaction for the purpose of determining its cost. And there was no cost in 1901. Where value is to be used in place of actual cost or selling price, the Revenue Act so provides, as in Section 202 (b) relating to exchanges of property. The Act contains nothing to warrant the determination of gain or loss on the basis of value as of the date when property, acquired and used as a private residence,

is leased to others. Moreover, in the present case there is no finding or evidence as to the value of the property in question in 1901.

The Treasury Department has consistently taken the view that the question whether or not a transaction is entered into for profit is to be determined upon the basis of intention at the time of the acquisition of property without regard to subsequent changes in its use. Whatever ambiguity there may have been in Article 141 of Regulations 45 as originally promulgated, this is clearly the effect of the amended provision adopted on January 28, 1921, and contained without change in regulations under subsequent Revenue Acts that:

> Art. 141. *Losses.*—* * * A loss in the sale of residential property is not deductible unless the property was purchased or constructed by the taxpayer with a view to its subsequent sale for pecuniary profit.

This view has been set forth in a number of Treasury Department opinions and memoranda. 1 Cumulative Bulletin (Dec., 1919) 117; 5 Cumulative Bulletin (Dec., 1921) 141; Cumulative Bulletin II–1 (June, 1923) 95; Cumulative Bulletin II–2 (Dec., 1923) 119.

As pointed out by the District Judge, the reenactment of Section 214 (a)(5) without change in the Revenue Acts of 1921, 1924, and 1926 is some indication that Congress intended to approve and adopt the interpretation placed upon it by the Treasury Department. *United States* v. *Anderson,* 269 U. S.

422, 439; *Provost* v. *United States,* 269 U. S. 443, 458.

Until the decision of the Circuit Court of Appeals in the present case was rendered the United States Board of Tax Appeals followed the Treasury Department's interpretation of the law. *Appeal of John J. Madden,* 2 B. T. A. 702; *Appeal of Alice Grace D'Oench,* 3 B. T. A. 24; *Appeal of Fred L. Mandel,* 4 B. T. A. 1001. In *Appeal of Walter J. Ball,* 8 B. T. A. 180, the Board of Tax Appeals followed the decision of the Circuit Court of Appeals in the present case.

III

THERE IS NOTHING IN THE STATUTE TO JUSTIFY MAKING THE CHARACTER OF THE USE OF THE PROPERTY ON MARCH 1, 1913, DETERMINATIVE OF WHETHER OR NOT THE LOSS INCURRED UPON ITS SALE WAS DEDUCTIBLE

The opinion of the Circuit Court of Appeals (R. 26–27) appears to be based primarily on the theory that—

> * * * the situation of the property * * * when the income tax law of 1913 was passed, was a distinctively nonresidential and a distinctively business leasing of real estate for profit. We think we are justified in regarding the transaction here involved by its then and subsequent status.

From this the Circuit Court of Appeals apparently concluded that there was a deductible loss measured by the difference between the March 1,

1913, value and the selling price. But it seems clear that no new transaction was entered into on March 1, 1913. The transaction resulting in the loss was entered into either in 1887, when the property was acquired, or in 1901, when it was first leased, and we are unable to see any possible justification under the statute for making the situation on March 1, 1913, determinative of whether or not the loss is deductible.

Moreover, the conclusion of the Circuit Court of Appeals seems clearly inconsistent with *United States* v. *Flannery* and *McCaughn* v. *Ludington, supra.* Those cases held that March 1, 1913, value is not the basis for ascertaining gain or loss resulting from the sale of property, even in the case of property acquired before that date; that actual gain or loss is contemplated by the statute and the provision with respect to March 1, 1913, value is merely a limitation upon the amount of the actual gain or loss that would otherwise have been taxable or deductible.

It follows logically that the date on which the transaction was actually entered into, and not March 1, 1913, which is merely the date upon which the 1913 income tax law became effective, must be looked to in order to determine whether the transaction was entered into for profit.

IV

IF THE TRANSACTION TERMINATED BY THE SALE OF THE PROPERTY IN QUESTION WAS ONE ENTERED INTO FOR PROFIT, THE ONLY LOGICAL BASIS FOR DETERMINING GAIN OR LOSS IS THE VALUE IN 1901, WHEN THE RESIDENTIAL USE CEASED AND THE LEASING BEGAN, AND AS THIS DOES NOT APPEAR IN THE CASE THERE IS NO SHOWING THAT ANY LOSS WAS SUSTAINED

If it be assumed that the transaction terminated by the sale of the property in question in this case was one entered into for profit within the meaning of Section 214 (a) (5) of the Revenue Act of 1918, and that any loss sustained as a result of such transaction was a proper deduction in computing net income, the respondents are faced with the further difficulty that there is nothing in the case to show that any loss was sustained.

As we have pointed out before, it would be wholly illogical to take the cost at the time the property was acquired in 1887 as the basis for ascertaining gain or loss and at the same time give no effect to the fact that the acquisition was not for profit. If the transaction terminated by the sale was the one entered into in 1887, there was a loss, but it is not deductible because the transaction was not entered into for profit.

To take the March 1, 1913, value as the basis for ascertaining gain or loss would be clearly inconsistent with the decisions of this Court in *United States* v. *Flannery* and *McCaughn* v. *Ludington, supra.*

The only remaining basis for ascertaining gain or loss is the value in 1901, when the property ceased to be used as a residence and was leased to persons other than the taxpayer. This would at least be a logical basis for ascertaining the gain or loss resulting from the retention of the property as an investment, although, as stated above, we think it doubtful whether the statute contemplates the use of such a basis. But in any event, there is absolutely nothing in the case to show the value of the property in 1901. Consequently, if such value is the proper basis for ascertaining gain or loss, the respondents have failed to show that any loss was sustained.

CONCLUSION

The judgment of the Circuit Court of Appeals should be reversed.

WILLIAM D. MITCHELL,
Solicitor General.
GARDNER P. LLOYD,
Special Assistant to the Attorney General.

FEBRUARY, 1928.

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